Evolution of Credit Methodologies Concept Paper

Over the past decade, the determinants of the success of microfinance credit methodologies have received extensive attention from both practitioners and academics.[1] The resulting literature reflects consensus on the principles for the successful provision of microfinancial services that address the two central problems of all financial markets: imperfect information and contract enforcement difficulties. Microfinance technologies attempt to overcome these problems by developing non-traditional mechanisms to screen applicants, monitor the actions of borrowers, and create incentives to repay.[2]

Many elements of these technologies impose costs on clients that they would prefer not to pay, or may result in services that are less than ideal. For example, some customers would prefer not to co-guarantee loans or participate in group meetings, which are ingredients of group lending methodologies; for other clients, the initial loan size required by sequential lending may be too small for the needs of their enterprise. These features have evolved in order to minimize the risk associated with providing financial services to disadvantaged communities.

Having successfully controlled the credit risk, microfinance methodologies are now entering a new evolutionary phase as they become more responsive to the demands of the customers. This change in approach reflects the evolving needs of microentrepreneurs, the maturation of the institutions, and changes in the markets in which the microfinance institutions (MFIs) operate. In this new phase, MFIs are struggling to balance three potentially competing objectives: 1) to reduce the costs of microfinance for both borrower and lender; 2) to widen the range of microfinance products available to the clients; and 3) to accomplish objectives 1 & 2 without increasing the credit risk. These three desired objectives are not independent of each other, and may require trade-offs.

An understanding of this evolutionary process informs the future of microfinance methodologies. This framework for analysis, summarized in the box below, outlines three important questions about the evolution of microfinance technologies: why do they change; how do they change; what do they change into.

I) Why do methodologies change?

By outlining the causes that drive MFIs to modify their methodology or introduce new products, this research may help less advanced lenders critically evaluate their approach, be open to the possibility

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[1] Some of the previous work on this topic is addressed by the following: Boomgard 1989, *A Stocktaking of USAID Microenterprise Projects*; Berenbach and Guzmán 1992, *The Solidarity Group Methodology Worldwide*; Yaron 1994, *What Makes Rural Finance Institutions Successful*?; Rhyne and Rotblatt 1994, *What Makes Them Tick?;* Rhyne and Otero (eds.) 1994, *The New World of Microenterprise Finance*; Schmidt and Zeitinger 1994, *Critical Issues in Small and Microbusiness Finance*; Christen *et al* 1995, *Maximizing the Outreach of Microenterprise Finance,* Schneider (ed.) Forthcoming, *Microfinance for the Poor.*

[2] Key ingredients of successful microlending methodologies include convenient and timely service to borrowers, simple application procedures, small short-term loans and gradual loan size increases based on repayment history, reliance on character and/or non-traditional collateral, strong relationships between the lender, borrower and the community, and immediate follow up on delinquent loans.

of change, and better anticipate the challenges that change implies. By describing failed attempts to introduce changes, lenders that are anxious to diversify their products before they have sufficient capacity may proceed with some restraint. The impetus for change falls into three interrelated categories: the institution, the clients, and the market.

The institution. The most obvious reason an institution changes its lending methodology is because it does not work. A dysfunctional methodology may produce various manifestations of weakness, such as a poor quality portfolio, high client desertion, difficulty enforcing contracts, the inability to reduce costs sufficiently or to achieve sustainability. To become sustainable, MFIs may change their methodology to increase scale and improve efficiency. Decisions to modify product pricing, cut costs and increase staff productivity have significant ramifications on the lending methodology.

The clients. The expansion of client businesses and the maturation of client-lender relationships may generate demand for new types of products or heighten expectations about product quality and variety. The provision of new services may extend beyond the scope of the organization's existing technologies. For example, an institution that only provides working capital loans will have to develop new loan assessment procedures if it introduces a fixed asset product. Progress in this direction will improve the quality of microfinance institutions as they diversify their loan portfolios and retain their best clients.

The market. Lending methodologies also evolve because an MFI operates in an increasingly competitive environment. When clients have institutional choice, microlenders become more responsive to customer demand in order to stave off desertion. It is important to explore how MFIs retain their clients, and attract new clients, in a competitive environment. Increased success in the microfinance industry will also attract other types of institutions to niches of the micromarket. These new entrants may bring innovations that diversify microfinance methodologies. Alternatively, an expanding MFI may wish to branch into new markets, such as rural areas or consumer loans. This would require employing new methodologies or modifying existing ones.

II) How do institutions change their lending methodologies?

There has been little analysis of the product development process in the microfinance industry. This is a critical topic because MFIs need the tools to shape technologies to their market rather than embracing existing designs. By learning the process of developing new products or modifying existing ones, lenders can appropriately tailor their methodologies to local conditions.

Do MFIs really know what their clients want? Most microlending methodologies emphasize risk reduction over the credit demands of the target population. This has been possible because MFIs often operate in monopoly markets. But the market is becoming more competitive. In addition, some of the more mature institutions now feel comfortable with their ability to manage risk and want to improve the quality of their services. Therefore, it is important for them to develop mechanisms to monitor the appropriateness of their products. This raises key questions about product research and development:

- How do institutions conduct market research and how does this research process inform the institution's lending methodology?
- If the institution knows what its clients want, how does it balance their demands with the institution's need to limit credit risk?

One dimension of this evolution is the introduction of new products. Lenders must manage product development so that they develop a set of products that are consistent and protect the integrity of the organization. For example, if a group lending institution introduces an individual product, will this undermine the cohesion of the groups? Or, how will the introduction of fixed asset loans affect the demand for working capital loan products? MFIs must also have the institutional capacity to administer multiple products. This raises questions about organizational structure, information systems and staff training:

- What challenges must be addressed to introduce new products *within* the MFI?
- Can cost, productivity, and profitability data for different products be disaggregated?
- Do loan officers handle multiple products or do they specialize?
- Is it ever appropriate for clients to have several concurrent loans?
- How does the staff react to new products and what can be done to increase its willingness to move ahead into uncharted territory?

III) What does the methodology evolve into?

It is also important to consider the product—what the methodology evolves into—in order to evaluate the product development process. In doing so, this research can identify innovations and new directions in the field, and expand the frontiers of microfinance. In reviewing new microfinance products, it is important to consider the following questions:

- What makes new products successful, or why are they unsuccessful?
- Is there a causal relationship between the process of developing new products and its ultimate success?
- How does the product balance the demands of the clients and the need for reduced costs, without increasing the credit risk, or does the institution compensate for higher risks by charging higher interest rates?

The Deliverables

C *Product Development*

To adequately address product development, it is necessary to separate this topic into two distinct deliverables, a technical note and a comparative analysis.

Technical Note on Product Development. The first step in addressing this important issue is to prepare a technical note outlining the product development process based on experiences in the formal financial sector. This document will explain why financial institutions develop new products and appropriate contexts for new product development. This technical note will then present different approaches to conducting market research, and highlight the importance of assembling an inter-departmental task team to design the product. The next phase of the development process covered by this study is pilot testing, profitability analysis and product refinement. Finally, this document will also outline the methods for introducing well-tested products on a wide scale including staff training, new product marketing, and profitability analysis.

A Comparative Analysis of Product Development. When the technical note is completed, it will be made available to MFIs who are planning to develop new loan products.[3] The second step is to prepare a companion piece that chronicles the product development process as it is actually implemented by two or three institutions over a period of 12 to 18 months. This comparative analysis will monitor institutions that volunteer to use the framework outlined in the technical note to develop new products and are willing to have that process documented by MBP. Possible products that may be developed include: an urban lender that modifies its methodology for the rural market; a new loan product developed for start-up enterprises; a fixed asset loan product developed by an institution that has specialized in working capital loans; and a line of credit or a credit card product.[4]

Graduate Loans: A Comparative Analysis

Group lending methodologies (peer group and village banking) are intended to reduce the transaction costs of microlending and provide a guarantee mechanism. While some borrowers benefit from the social support system inherent in group methodologies, for other microentrepreneurs, particularly those with growing businesses, the group approach is not always a good fit. As a result, many MFIs that have relied solely or primarily on group lending are introducing individual loan products for clients who “graduate” from the group approach to ensure that they retain their best borrowers.

This comparative analysis will investigate two examples of institutions that have introduced graduate loans to determine why they developed the new product, how they introduced the it, and what the product looks like. This study will also explore the following questions:

C How does the MFI avoid losing all of its group clients to individual loans?
C What guarantees are required to replace the peer group?
C How does the addition of individual loans affect the institutional structure and culture?

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[3] One method of recruiting MFI subjects for this analysis is by contacting institutions that apply for grants from the MBP grant facility.
[4] This deliverable will not consider the development of graduate loans since that is the focus of another deliverable.

- Does the institution develop expertise with individual lending so that it eventually offers loans to microentrepreneurs who have not had group loans?
- How does the MFI ensure that it does not lose its focus by shifting its portfolio from micro to small enterprises?